

Research and Experimentation Advances Competitiveness at Home (REACH) Act REP. PAT TIBERI & REP. JOHN LARSON

Summary

The R&D tax credit has proven to be an effective incentive to stimulate research investment and help maintain and create high-paying jobs and activities that stimulate positive economic benefits. The REACH Act would enhance the R&D credit, increase its effectiveness and reduce the cost of compliance and administrative burden associated with it to make the U.S. more competitive, drive innovation, and increase investment, productivity, jobs, and wages.

Background

The R&D tax credit was enacted in 1981 and was for many years a temporary credit that was extended by Congress 16 times until finally becoming permanent in 2015. Some of those extensions included modifications to the credit, including the addition of the Alternative Simplified Credit (ASC) in 2006. Under current law, a taxpayer can receive a tax credit for up to 20% of qualified research costs over a base amount calculated using a taxpayer's research activities and sales from 1984 to 1988. Alternatively, a taxpayer can elect to use an easier formula to calculate the Alternative Simplified Credit (ASC) which is 14% of qualified research costs based on the average of the three preceding years for which the credit is being determined. However, if the taxpayer elects to utilize the R&D tax credit, the taxpayer's deduction for research costs is reduced by the amount of any R&D tax credit (Section 280C of the Code). For 2016 and beyond, certain small business taxpayers can claim the R&D credit against their Alternative Minimum Tax liability and qualified small businesses can use their R&D credit to offset a portion of their payroll tax liability.

SECTION 1

Increase in Alternative Simplified Credit Rate

The REACH Act would simplify and strengthen the R&D tax credit by increasing the ASC formula to 20% from 14%, the same rate as the regular credit. The ASC is calculated on qualified research expenses that exceed 50% of the average qualified research expenses for the three preceding taxable years. For start-up firms without any research expenses in any one of the preceding three years, the credit would be equal to 10% (up from 6%) of the taxpayer's qualified research expenses for the year. Although many taxpayers still use the regular credit, increasing the use of the ASC would greatly simplify credit calculations and help improve credit administration by eliminating a substantial amount of recordkeeping and documentation required to substantiate the regular credit's historical base period.

SECTION 2

Allocation of Research Expenses Among Business Components

The Internal Revenue Service frequently takes the position that the research credit is disallowed unless the taxpayer tracks and details its cost by business component, notwithstanding the fact the activities constitute qualified research activity. The bill would clarify that a taxpayer could use reasonable estimation techniques to measure employee research activities among business components.

SECTION 3

Inclusion of Qualified Upper-Level Employees in Research Expense Calculation

The IRS frequently disallows wages connected with qualified services performed by anyone above first-line supervisor. In many organizations the company founder, owner or other members of top management may be the innovative idea generators in the company and their efforts should be eligible for the credit.

The bill would clarify that as long as an employee is engaged in qualified research, the time spent on qualified research activities would still qualify even if the employee has a managerial position.

SECTION 4

Repeal of Exclusion of Adaptive Research

The IRS has excluded research activities related to adapting existing business components from the credit, even though the activity otherwise qualifies for the credit. The bill would provide that the research related to adaptation of an existing business component that otherwise meets the definition of qualified research would qualify for the credit.

SECTION 5

Inclusion of Cost Reduction Research

In addition to function, performance, reliability and quality, a significant driver of R&D activities is to reduce costs in order to remain competitive. The IRS has disallowed projects whose primary purpose was cost reduction because they did not deem it to be related to function, performance, reliability or quality. The bill would clarify that research related to reducing the cost of a product or business component would be treated as qualified research, provided the other relevant requirements are satisfied.

SECTION 6

Inclusion of Obsolescence Mitigation

Often component parts used to manufacture a particular product become obsolete, and are thus no longer available to purchase. For many advanced technologies, replacing any part (even with a newer, better part) requires a redesign of the entire system. IRS agents have disallowed the otherwise qualified expenses associated with such a redesign on the grounds that the end product was not necessarily “new or improved”.

The bill would clarify that the research related to the obsolescence mitigation of a product or business component would be treated as qualified research, provided the other relevant requirements are satisfied.

SECTION 7

Election of Reduced Credit May be Made on Amended Return

Under section 280C, a taxpayer is not allowed a deduction for research expenses that equal the amount of the R&D tax credit. However, a taxpayer may elect to take a reduced R&D tax credit and a full deduction for allowable research expenses. Currently, this election can only be made on an original tax return. The bill would provide that a taxpayer can also make the election under section 280C on an amended return.